No. 16051

In the United States Court of Appeals for the Ninth Circuit

AMERICAN PROPERTIES, INC., and the ESTATE OF STANLEY S. SAYRES, DECEASED, HAROLD L. SCOTT, and A. R. MUNGER, EXECUTORS, and MADELEINE A. SAYRES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decisions of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
I. HENRY KUTZ,
C. GUY TADLOCK,
Attorneys,
Department of Justice,
Washington 25, D. C.

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The opinion of the Tax Court (R. 25-58) is reported at 28 T. C. 1100.

JURISDICTION

This petition for review (R. 61-63) involves additional federal income taxes determined against American Properties, Inc., for the taxable years 1949 and 1950 in the respective amounts of $495.78 and

$3,601.31; and against Madeleine A. Sayres and Harold L. Scott and A. R. Munger, Executors of the Estate of Stanley S. Sayres, deceased,[1] for the taxable year ending October 31, 1949, in the amount of $10,400.69, and income taxes and penalties for the taxable year ending October 31, 1950, in the respective amounts of $12,830.51 and $641.53. (R. 8-9, 18.)[2] On February 17, 1955, the Commissioner of Internal Revenue mailed to the taxpayers notices of deficiencies covering the above amounts. (R. 6, 16.) Within 90 days thereafter and on May 11, 1955, the taxpayers filed petitions with the Tax Court for a redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939, as amended. (R. 10, 23.) The decisions of the Tax Court were entered on February 14, 1958. (R. 59, 60.) The cases are brought to this Court by a petition for review filed May 7, 1958. (R. 63.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

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[1] During the pendency of the actions in the Tax Court, Stanley S. Sayres died and his executors were substituted as parties.

[2] The following proceedings were consolidated for hearing and decision in the Tax Court: American Properties, Inc., Docket No. 57,748; Stanley S. Sayres, Docket No. 57,749; Madeleine A. Sayres, Docket No. 57,750; and Stanley S. Sayres and Madeleine A. Sayres, Docket No. 57,751. The taxpayers have not petitioned for a review of Docket Nos. 57,749 and 57,750 which involved a salary deficiency for 1948. (R. 25, 61.)

QUESTION PRESENTED

Whether the Tax Court erred in holding that expenditures made (and certain depreciation allowances taken) by taxpayer, American Properties, Inc., in connection with designing, constructing, maintaining, and racing speedboats, were not deductible business expenses within the meaning of Section 23(a) of the Internal Revenue Code of 1939, but rather were personal hobby expenses of the corporation's sole stockholder, the taxpayer Stanley S. Sayres and his wife Madeleine A. Sayres, and therefore were taxable to them as personal income.

STATUTES AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*.

STATEMENT

The facts as found by the Tax Court (R. 27-40) may be summarized as follows:

Stanley S. Sayres and Madeleine A. Sayres were husband and wife during the years in issue and up to the time of his death on September 16, 1956. Stanley was in the automobile business and in 1931 he purchased the Williams Auto Company in Seattle changing its name to American Properties, Inc. He owned all but one qualifying share of stock in this corporation. Stanley, during the years in issue, was the principal stockholder of the American Automobile Company which operated an automobile dealership in Seattle in and on premises owned by American Properties, Inc. (R. 27-28.)

Stanley [3] was interested in outboard motor boat racing prior to his moving to Seattle in 1931, and had a long standing and continuing interest in speed. It was his desire to drive a boat faster than any other person. (R. 28.)

Subsequent to his moving to Seattle in 1931 the taxpayer for several years did not engage in boat racing. However, at some time prior to 1948 he purchased a used racing boat which had previously attained a speed of 80 m.p.h. and named it Slo-Mo-Shun. Thereafter he built Slo-Mo-Shun II and Slo-Mo-Shun III. In the design, construction, operation, and maintenance of Slo-Mo-Shun III, the taxpayer retained technical assistance of experts who were recognized as outstanding in their fields. Ted Jones, his boat designer, was employed as an engineer with an airplane company, and his work for the taxpayer was done at nights, on weekends, and on holidays. Anchor Jensen, of the Jensen Motor Boat Company, was the builder. The taxpayer, Jones, and Jensen attended the 1948 Gold Cup races in Detroit in August, 1948, and after their experience with the first Slo-Mo-Shun and Slo-Mo-Shun II and III they recognized the tremendous room for improvement in the designing of racing boats and that there were possibilities of profits to be made in the designing, construction, and sale thereof. At that time they considered also the possibility that the Navy might be-

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[3] Stanley is hereinafter referred to as the taxpayer and American Properties, Inc., by its name or as the corporation.

come interested in the basic design of their boats and might become an important customer. Jones proceeded to design Slo-Mo-Shun IV which would be revolutionary in the field of unlimited hydroplane boats. He used the identical design which he had used for years in building and racing limited class boats. By August, 1949, Jones and the taxpayer concluded that Slo-Mo-Shun IV, which was then in the process of construction, would prove to be far superior to boats currently being used. (R. 28-29.)

The taxpayer consulted his attorney, his accountant, and his financial adviser, an official of the Seattle-First National Bank, who all agreed on the profit possibility in the designing, building, and sale of boats. The banker advised against the undertaking in an individual capacity. In discussions with the attorney the taxpayer suggested that inasmuch as the articles of incorporation of American Properties, Inc., already contained provisions which would authorize the construction and sale of boats and marine supplies or engines, such corporation might undertake the venture without the necessity of creating a new corporation. (R. 29.)

The minutes of a meeting of the directors of the corporation held on August 31, 1949 (R. 29), contain the following (R. 30-31):

> Preliminary discussions had been had with reference to this corporation entering the field of boat building, ownership and management. Counsel reported that the Articles of Incorporation were sufficiently broad to warrant entry upon such a program.

Mr. Sayres in connection with the Country wide interest in power boat racing suggested that "Slo-Mo-Shun III" was in his opinion far superior to the major racing boats; that an improvement in design had been perfected and in his opinion "Slo-Mo-Shun III" was by no means the last word in the field. In other words, there would be continuous improvement and if sufficient time was devoted to experimental and engineering work other boats would become obsolete and the Seattle boat would be the pattern all over the Country.

He suggested that he believed if the Company would enter the field, do the necessary experimental and engineering work that not only was there money to be made in the manufacture and sale of racing crafts, but in the commercial field as well. That he believed the Government would itself be interested in the fastest type of boat that could be manufactured.

It was recognized that there would be substantial experimental cost to lay the groundwork for future development.

He further stated that he was willing to transfer title of Slo-Mo-Shun III to the corporation if the corporation would continue in an endeavor to work out improvements in design and engineering. He particularly suggested that a new improved Slo-Mo-Shun should be designed and built for actual racing use.

Mr. Sayres also advised that he had substantial offers for Slo-Mo-Shun III and had no doubt of the salability of Slo-Mo-Shun the IVth and boats of that design and class.

It was agreed that it was to the best interest of the corporation to enter this new field and

> proceed with the construction of a new boat upon the improved design of Slo-Mo-Shun III, all with the end in view of when the time was propitious getting into commercial operation.
>
> Mr. Sayres was authorized to proceed accordingly. (R. 31.)

At this time Slo-Mo-Shun IV was in the process of being built and was launched in October, 1949. (R. 31.)

Some time prior to October 31, 1949, the corporation paid to the taxpayer an amount of $14,690.30, which was the amount that had been expended by him in the construction of Slo-Mo-Shun III and of partial construction of Slo-Mo-Shun IV. (R. 31.)

In 1949 there were no registration or licensing requirements with regard to boats of this character and no patents were taken on the design of these boats. The taxpayer did not enter into any formal document transferring title of either Slo-Mo-Shun III or Slo-Mo-Shun IV to the corporation. (R. 31.)

The taxpayer, in filling out forms with the county assessor of King County, Washington, for personal property tax purposes as of January 1, 1950, and 1951, indicating that he was the owner of Slo-Mo-Shun IV, left blank the part of such forms calling for information as to whether he had transferred title. He belonged to the Seattle Yacht Club and has always been registered with the American Power Boat Association as the owner of Slo-Mo-Shun IV and V. The rules of that association provided, among other things, that each boat entered for a sanctioned race must be the bona fide property of the person

in whose name she is entered, who must be a racing member of the association and a member of a club belonging to the association; that corporations or business concerns may not enter sanctioned races (although they may be members of the association) and may only enter a boat as the bona fide property of a club member who is also a racing member of the association, either by ownership or by charter. (R. 31-32.)

In June of 1950, Slo-Mo-Shun IV, driven personally by the taxpayer on Lake Washington, established a new world straight-away speed record of 160 m.p.h., breaking the 11-year-old record of 141 m.p.h. Recognizing the capabilities of this boat and the possibility of still further improvements of design in a model to be built, the taxpayer sought a contractual arrangement which would include Ted Jones, the designer, and Anchor Jensen, the builder. However, because of disagreement as to technical engineering principles Jones refused to sign an agreement which would include Jensen as a party. On July 17, 1950, an agreement was executed "by and between AMERICAN PROPERTIES, INC., (and/or S. S. SAYRES) Party of the First Part, and TED O. JONES, Party of the Second Part," which provided that whereas the first party had financed construction of Slo-Mo-Shun III and Slo-Mo-Shun IV and whereas second party designed both of those boats and assisted in development, construction, and testing, the parties agreed as follows: The second party agreed to work exclusively for the first party in the design and development of "GOLD CUP" and "UNLIMITED" classes of

racing boats during the existence of the contract and a period of 1 year thereafter; second party agreed not to disclose to others any basic or essential features of design, construction, or development; first party agreed that when constructing racing boats, only second party would be employed to design such boats and to supervise construction, and that upon all boats sold by first party, in whom title should always rest, second party would receive a fee of $5,000 or 10 per cent of sale price, whichever was greater, this being in addition to time and material charges such as had been paid in the past; first party agreed that if Slo-Mo-Shun IV should be sold for an amount greater than cost, first party would pay second party 10 per cent of actual net profit after taxes, or a flat sum of $5,000 whichever was greater, in which case second party would, in consideration thereof, design a new Unlimited class racing boat for first party at no additional fee; both parties agreed that in event of any sale of plans and designs of Gold Cup and Unlimited boats, first party would pay second party a fee of $2,500 together with traveling expenses and a fee of $25 per day actually spent in supervising construction. It was provided that the agreement should continue until terminated by written notice of either party, giving 180 days' notice. It was signed by S. S. Sayres as president of American Properties, Inc., and in his individual capacity, and by Jones. (R. 32-34.)

In July of 1950, Slo-Mo-Shun IV, driven by Ted Jones, won the Gold Cup race. Subsequently, Jones was approached by others seeking boats of the design

of Slo-Mo-Shun IV, including Horace Dodge who sought to have two boats built, offering $50,000 per boat. Jones sought approval of the taxpayer which was refused. (R. 34.)

Lou Fageol, a wealthy sportsman who was one of the top two or three drivers in the country, had driven Slo-Mo-Shun IV on August 2, 1950, and won the Harmsworth Trophy. He drove Slo-Mo-Shun V and won the Gold Cup in 1951. (R. 34-35.)

In August, 1950, the Seattle-First National Bank loaned American Properties, Inc., $26,000 to be used in operations in connection with the boats. No collateral was given for the loan. (R. 34.)

In February, 1951, construction of Slo-Mo-Shun V was commenced for the purpose of entering the 1951 Gold Cup races. The taxpayer prevailed upon Jones and Jensen to work together in the construction of the boat. The boat was constructed at the premises of the Jensen Motor Boat Company under the supervision of Jones and with the aid of some of Jensen's boat builders. The boat was completed by the end of July, 1951. Jones received $5,000 for designing Slo-Mo- Shun V in addition to compensation received on an hourly basis for its construction. (R. 34-35.)

In 1952 Slo-Mo-Shun IV, driven by Stanley Dollar, a wealthy man of the Stanley Dollar Steamship Lines, won the Gold Cup race. Joe Taggart, who has had as much racing experience as Fageol, also drove the Slo-Mo-Shun boats in competition. In 1953 and 1954 either Slo-Mo-Shun IV or Slo-Mo-Shun V won the Gold Cup races. The Slo-Mo-Shun boats have also won the Martini-Rossi Trophy for the fastest heat in

a Gold Cup race and the Aaron DeRoy Plaque for the fastest over-all race average. The taxpayer's name appears on the Gold Cup as the winner and the various trophies which were won by Slo-Mo-Shun boats were kept at the Seattle Yacht Club. There were no cash prizes in racing these boats. (R. 35.)

The taxpayer did not himself personally drive any of the boats in closed course competitive races, such as the Gold Cup or the Harmsworth races. He did drive in speed competition, as in 1950 when he broke the world's straightaway speed record. (R. 35.)

In November of 1951, Ted Jones left Seattle and went east to work as a boat designer for another concern and ceased to operate under the agreement of 1950. No formal notice of termination of the contract was ever given by either party. Because he felt restrained by the contract of 1950, Jones did not, for a number of years, build any boats for others of the design of the Slo-Mo-Shun boats, although he had many opportunities to do so. However, commencing in January, 1954, he did design a number of boats for various individuals throughout the country, employing the design of the Slo-Mo-Shun boats. In 1956, there were about 20 boats eligible for competition in the unlimited class, of which all but 4 were of the basic Slo-Mo-Shun design, none having been sold by the taxpayer or American Properties. (R. 35-36.)

Members of the crew of the various Slo-Mo-Shun boats included highly skilled technicians who worked in their spare time since they were full time employees of other organizations. None of them was employed by either American Properties, Inc., or

American Automobile Company. Jones was compensated for designing the boats and Jensen was paid for his work in building them. (R. 36.)

The principal construction work took place at the Jensen Motor Boat Company, but the engine work was done at the premises of American Properties, Inc., then under lease to American Automobile Company, where there was a machine shop for assembling engines, and engines and parts were stored at these premises. The small handtools which were used were the properties of American Properties, Inc. Only occasionally was equipment of American Automobile Company used, and an electric hoist which was used was not the property of American Automobile Company. (R. 36.)

All costs of completing and operating Slo-Mo-Shun IV and the costs of building and operating Slo-Mo-Shun V were borne by the corporation, including the expenses incurred in racing them, such as traveling expenses of the crew to Detroit in 1950. (R. 36-37.)

The building owned by the American Properties, Inc., was located about 1½ to 2 miles from the nearest navigable body of water. Slo-Mo-Shun III was moored at a dock at the taxpayer's residence on Lake Washington. Later the taxpayer constructed another residence on Lake Washington to which he moved in December 1950, and the Slo-Mo-Shun boats were then housed in the boathouse at such residence. At times the boats were housed at the Jensen Motor Boat Company, which is on Lake Washington about 5 miles from the taxpayer's new residence. (R. 37.)

Greater Seattle, Inc., a nonprofit, publicly subscribed corporation which promoted the annual Seafair and other sporting events, sponsored campaigns to raise money for the operation of the Slo-Mo-Shun boats because of the advantage to Seattle of bringing the Gold Cup race to Seattle. In 1950 the amount contributed by Greater Seattle, Inc., for this purpose was $6,912.15. This contribution, whether paid to the taxpayer in the first instance, or to the corporation, was ultimately received by the corporation to defray part of the expense of operating Slo-Mo-Shun IV. In subsequent years other contributions were also received from Greater Seattle, Inc., through campaigns for public subscription. In sponsoring campaigns for raising money for this purpose, Greater Seattle, Inc., held the taxpayer out as the owner of the boats. Newspaper articles also consistently referred to the taxpayer as the owner of the boats. The official programs of the Gold Cup races listed him as the owner. (R. 37-38.)

The taxpayer has never sold any of the Slo-Mo-Shun boats or any designs therefor. After Slo-Mo-Shun IV had been constructed, some civilian representatives of the Navy Department examined it and observed it in action. There was no subsequent indication that the Navy would be interested. (R. 38.)

In its income tax returns for the calendar years 1949 and 1950 the corporation showed its principal business activity as "Real Estate" and "Lessor of Building," respectively. It reported net income of $8,423.26 in 1949 and a net loss of $1,561.41 in 1950. Its returns show that it had surplus at December 31,

1949, of $74,659.49 (of which $37,497.43 was earned surplus) and at December 31, 1950, surplus of $71,-260.73 (of which $34,098.67 was earned surplus). (R. 38.)

In the calendar year 1949 the corporation expended $2,155.56 in operation and maintenance of the boats, which it deducted on its corporate tax return as business expenses. In addition, the corporation expended $561.39 as additional boat expense which it did not deduct on the corporate return. (R. 38.)

For the calendar year 1950 the corporation expended $19,300.58 for operation and maintenance of the boats and deducted on its return the amount of $12,388.43 (after offsetting the contribution from Greater Seattle, Inc., in the amount of $6,912.15). In the return there was included $1,000 as income from endorsement of an oil product. (R. 38-39.)

The corporation capitalized on its books and its returns for 1949 and 1950 the amounts expended for construction of the boats and related equipment (including the amount of $14,690.30 which was paid by the corporation to the taxpayer as hereinabove stated). In the 1949 return the balance sheet at the end of the year includes in depreciable capital assets the amount of $18,609.16 for boats and equipment, but no depreciation was claimed. For 1950 the amount of capitalization of boats and equipment at year end was $22,323.37 upon which depreciation was taken in the amount of $5,830.84. The Commissioner determined that the boating activities of the corporation were not carried on as a business for profit and disallowed the expenditures for operation and main-

tenance of boats in 1949 and 1950, and the item for depreciation in 1950. The Commissioner, therefore, included as additional income of the individual taxpayers all amounts expended by the corporation in connection with the boats. Inasmuch as the individuals were on a fiscal year ending October 31, whereas the corporation was on a calendar year basis, the Commissioner determined the amounts which had been expended during the taxable years of the individuals. For the fiscal year ended October 31, 1949, the Commissioner attributed additional income to the individuals in the amount of $16,401.51, consisting of $1,149.82 of disallowed corporate expenses to October 31, 1949, $561.39 representing additional boat expense paid by the corporation and not deducted on the corporate return, and $14,690.30 representing the amount paid to the taxpayer by the corporation and capitalized on the corporate return. For the fiscal year ended October 31, 1950, the Commissioner attributed additional income to the individuals in the amount of $16,595.31, consisting of $1,005.74 expended by the corporation as boat expenses from November 1 to December 31, 1949, $7,956.50 of net expenses from January 1 to October 31, 1950, and $7,633.07 expended during the year ended October 31, 1950, and capitalized by the corporation. (R. 39-40.)

On June 29, 1951, the corporation filed a claim for refund of taxes for the year 1949, based upon the carryback of a claimed net operating loss for 1950. On August 19, 1952, the corporation filed another claim for refund for the year 1949, based upon a claim that it understated its net operating expenses

by the amount of $561.39 referred to hereinabove. (R. 40.)

The Tax Court, in upholding the determinations of the Commissioner, found that the activities of the taxpayer and the corporation during the years in question with respect to the boats were not conducted with the intention of making a profit and such activities did not constitute the conduct of a trade or business by either the taxpayer or the corporation. (R. 40.)[4]

SUMMARY OF ARGUMENT

The questions of what is or what is not a trade or business and whether particular expenditures were proximately related to the carrying on of a trade or business are factual. The burden of bringing the expense deduction within the provisions of the statute is upon the taxpayer.

The courts have held that in a factual situation the lower court's findings will not be set aside unless clearly erroneous and unless the ultimate conclusion is adduced from an erroneous view of the law.

A review of the record by this Court will demonstrate that the taxpayers did not carry their burden of proof and that the Tax Court's findings that the boat venture was not a business, but rather a personal hobby, are not only free from clear error, but

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[4] The Tax Court also ruled adversely to the individual taxpayers on a second issue concerning omissions of salary income and additions for negligence in the year 1950 (Tax Court Docket No. 57751, R. 60), but taxpayers do not raise this issue in this Court (Br. 3).

are warranted fully when considered in the light of the decided cases on the subject.

The taxpayers contend that a profit motive was present, that the boat venture was conducted for the purpose of financial gain, and therefore, the expenditures made in furtherance thereof were incurred in carrying on a trade or business and are deductible under the statute.

The facts of record are contrary to such contentions on the part of the taxpayers, and show, among other things: (1) taxpayer was a prominent sportsman who gained national fame as an owner and driver of high speed power boats and he engaged in motor boat racing as a hobby for many years prior to the years in issue; (2) in 1949, he attempted to shift the financial burden to one of his corporations, although he continued to refer to the activity as his hobby and held out to the public that he personally was expending large sums in furtherance thereof; (3) in subsequent years, only two unlimited class racing boats were constructed and placed in competition, winning many top national awards; (4) after this, numerous offers were received for the design and construction of the boats, but, all were turned down by taxpayer; and (5) no attempt was ever made to sell any boats and no financial gain was realized.

The Tax Court exercised its function with care and its findings are amply supported by the record and its decisions should be affirmed.

ARGUMENT

The Evidence Supports the Tax Court's Holding That Expenditures Made (and Certain Depreciation Allowances Taken) By Taxpayer, American Properties, Inc., In Connection With Designing, Constructing and Racing Speed Boats, Were Not Deductible Business Expenses, But Rather Were Personal Hobby Expenses of the Corporation's Sole Stockholder, the Taxpayer Stanley S. Sayres and His Wife Madeleine A. Sayres, and Therefore Taxable To Them As Personal Income

A. *General*

The principal issue for determination on this appeal is whether the Tax Court erred in finding that the boat venture was not carried on for the purpose of realizing a profit, but rather was conducted as a hobby of the taxpayer, Stanley Sayres.

The taxpayers contend (Br. 24-25) that a profit motive was present, that the activities of designing, building, maintaining and racing boats were conducted for the purpose of financial gain, and therefore the expenditures made in furtherance of these activities were incurred in carrying on a trade or business and are deductible under the statute.

Section 23(a)(1)(A) of the Internal Revenue Code of 1939 (Appendix, *infra*) provides that in computing net income "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *" may be deducted. On the other hand, Section 24(a)(1) (Appendix, *infra*) of the 1939 Code provides that in computing net income "personal, living, or family expenses * * *" may not be deducted; and, under

well settled principles, capital expenditures are not deductible. *Shipp* v. *Commissioner*, 217 F. 2d 401 (C.A. 9th), and cases there cited.

The Tax Court found as a fact that (R. 40):

> The activities of the petitioner and the corporation during the years in question with respect to the boats were not conducted with the intention of making a profit. Such activities did not constitute the conduct of a trade or business by either petitioner or the corporation.

The question of what is or what is not a trade or business is factual, and the lower court's findings if based upon substantial evidence (and not adduced from an erroneous view of the law) will not be set aside unless clearly erroneous. *Higgins* v. *Commissioner*, 312 U.S. 212, rehearing denied, 312 U.S. 714; *United States* v. *Gypsum Co.*, 333 U.S. 364, 395, rehearing denied, 333 U.S. 869; *McDonald* v. *Commissioner*, 323 U.S. 57; *Morton* v. *Commissioner*, 174 F. 2d 302, 303 (C.A. 2d). See also Section 7482(a), Internal Revenue Code of 1954, and Rule 52(a), Federal Rules of Civil Procedure.

One of the important factors in determining the existence of a business is the presence or absence of a profit motive and such determination is likewise factual.[5] *Helvering* v. *Nat. Grocery Co.*, 304 U.S.

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[5] The intention to profit must be the primary or dominant purpose and incidental expectation or hope of the venture being profitable is not sufficient to constitute the operation of a business (*White* v. *Commissioner*, 227 F. 2d 779 (C.A. 6th), certiorari denied, 351 U.S. 939; *Coffey* v. *Commissioner*, 141 F. 2d 204 (C.A. 5th)); and the activity must not be

282, 289, rehearing denied, 305 U.S. 669. However, in making the ultimate finding as to whether the particular activity constitutes a trade or business the courts have considered, *inter alia*, taxpayer's normal and regular activities, his financial position, the extent and nature of the alleged business venture (particularly its relation to both taxpayer's regular operation and his outside interest), the financial record of the operation during all of the year of its existence, and the extent of taxpayer's activities in carrying on the venture as a commercial enterprise. *Brodrick* v. *Derby*, 236 F. 2d 35 (C.A. 10th); *Coffey* v. *Commissioner*, 141 F. 2d 204 (C.A. 5th); *Ewing* v. *Commissioner*, 213 F. 2d 438 (C.A. 2d); *Thacher* v. *Lowe*, 288 Fed. 994 (S. D. N.Y.). As the Fourth Circuit said in *Cecil* v. *Commissioner*, 100 F. 2d 896, 899:

> The taxpayers' intention is important (*Commissioner* v. *Field*, 2 Cir. 67 F. 2d 876, 877) but not necessarily controlling, as the nature of the enterprise and its financial results may be even more important.

Taxpayers make no contention, and indeed could not sustain a contention, that the expenditures in question were nonbusiness expenses paid or incurred for the production or collection of income (see Internal Revenue Code of 1939, Section 23(a)(2) (26 U.S.C. 1952 ed., Sec. 23)). But the Treasury Regulations dealing with such nontrade or nonbusiness

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conducted primarily for pleasure, exhibition or social diversion (*Deering* v. *Blair*, 23 F. 2d 975 (C.A. 10th); *Ewing* v. *Commissioner*, 213 F. 2d 438 (C.A. 2d)).

expenses are illuminating, in that they mark out a standard equally applicable to trade or business expenses and, indeed, express clearly the rule which the cases have applied in respect to claims of trade or business expense deductions, and which distinguishes a hobby from a profit-making enterprise. Thus Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939, reads:

> Sec. 29.23(a)-15. *Nontrade or Nonbusiness Expenses.*—
>
> * * * *
>
> (b) * * *
>
> Capital expenditures, and expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case, including the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer.
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> * * * *

Finally, the courts have held consistently that in a situation in which there is a claim for a deduction under the statute the taxpayer must assume the burden of proof and bring himself clearly within the scope and meaning of the section relied upon to support his claim. *Lykes* v. *United States*, 343 U.S. 118; *Deputy* v. *du Pont*, 308 U.S. 488; *New Colonial Co.* v. *Helvering*, 292 U.S. 435; *Welch* v. *Helvering*, 290 U.S. 111; *Commissioner* v. *Peurifoy*, 254 F. 2d 483 (C.A. 4th).

A review of the record by this Court will demonstrate that the taxpayers did not carry their burden of proof and the Tax Court's findings that the boat venture was not a trade or business, but rather a personal hobby, are not only free from clear error, but are clearly warranted by the record when considered in the light of the decided cases on the subject.

B. *Not a Business but a Hobby*

The Commissioner does not contend, as taxpayers seem to indicate (Br. 23-25) that an operation calling for the design and construction of boats cannot be carried on as a trade or business; but, only submits that under the evidence in this case, it can be held (and was properly held herein) that the expenses incurred by American Properties in 1949 and 1950, are not deductible as ordinary and necessary business expenses. Moreover, it is not contended that the particular venture could not be profitable if the taxpayer had operated it in fact as a business for profit. Indeed as the taxpayers point out in their brief (pp. 24-25), Jones went on with the venture after 1951

and made a "handsome profit". In order to constitute a business the venture must not only be entered into with a profit motive but must be carried on primarily and in truth as a business for profit. *Thacher* v. *Lowe*, *supra*, p. 995.[6]

We submit that, in spite of taxpayer's testimony (and the testimony of his advisers) to the contrary, the corporation never entered the business of boat design and construction. The Tax Court was warranted in weighing taxpayer's testimony and that of his accountant, lawyer and banker in the light of the evidence. Upon consideration of all the evidence the fact finder concluded that during the years in question the activities of taxpayer and the corporation with respect to the boats were not conducted with the intention of making a profit and that such activities did not constitute the conduct of a trade or business by either the taxpayer or the corporation and the Tax Court so found as a fact.[7] (R. 40, 51.) The minutes of the board of directors of the corporation

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[6] Taxpayers' citation of *Doggett* v. *Burnett*, 65 F. 2d 191 (C.A. D.C.) (Br. 25-26), states the basic principle clearly (p. 194) and in doing so supports the Tax Court in the instant case:

> The proper test is * * * whether it is entered into and *carried on in good faith* and for the purpose of making a profit, * * *. (Emphasis supplied.)

[7] Thus in the light of all the circumstances the Tax Court was warranted in concluding that the testimony of taxpayer's accountant, lawyer and banker indicated at the most that taxpayer had under consideration placing the corporation in the boat business and did not at all establish that this had actually been done or that the corporation had actually carried on a business venture for profit.

relied upon so heavily by taxpayers, indicate that commercial operations would not commence until "the time was propitious." (R. 31.)

The taxpayer was interested in speed from his youth and he had raced boats prior to his coming to Seattle in 1931. (R. 27-28, 78.) He evidently did not pursue this hobby activity in Seattle from 1931 to sometime prior to 1948, when he purchased the first Slo-Mo-Shun boat. (R. 28, 79.)[8] His interest increased after that time and he successively constructed Slo-Mo-Shun the II and III, and had partially constructed No. IV boat in 1949, when the so-called boat venture was discussed. (R. 28-29.) Each boat was a progression of the design of the previous Slo-Mo-Shuns and commencing with III, each was designed by Ted Jones, a well known expert in the field of designing speed or racing boats, and was built by Anchor Jensen at the Jensen Motor Boat Company facilities. (R. 28-29, 80.)

The taxpayer, together with Jones and Jensen attended the 1948 Gold Cup races in Detroit. (R.

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[8] Taxpayer attempts an analogy between his early and continued interest in speed and his entry into the automobile business and his interest in speed and his entry into the boat business. (Br. 23-24.) There is hardly a valid comparison when the facts show that he was in the automobile business for over 20 years during which time he was a major distributor for Chrysler and later a dealer. (R. 78, 116-117.) He no doubt conducted such enterprises in the normal manner, receiving and accepting hundreds (maybe thousands) of offers to purchase his products. (R. 116-117.) In contrast, he turned down every offer received for the design or construction of racing boats and made no sales thereof. (R. 143-145, 207-208.)

28-29.) They had completed the first three Slo-Mo-Shun boats and were convinced that there was room for improvement in the designing of racing boats. In addition, they believed that there was a possibility of realizing a profit from the design, construction and sale of such boats and that the Navy might be interested in the basic design. (R. 29.) The extent of taxpayer's willingness to consider the profit potentential of the boats is revealed by his subsequent action in refusing to consider *any* offers for the designing or construction of the boats, particularly those offers from persons who wanted to race the boats (R. 164-165, 168); and by the following testimony (R. 82-83):

> There is no money in racing in the Gold Cup races. There never has been. I would like to add that Jones and I were both agreed that there might be another field even more important than just race boats, and that is if the Navy should ever want a really high speed, well, what we might call a super PT boat. Now, whether the Navy is ever going to want one or not, I don't know.

This statement shows the importance taxpayer attached to racing for pure pleasure; and, that he might be willing to consider naval use of his design, but, despite the connotation to the contrary, and in view of his subsequent actions, he was unwilling for anyone else to have access to the Slo-Mo-Shun boat. As late as the spring of 1956, the date of the hearing below, the taxpayer was still not aware of the interest the Navy might have in the Slo-Mo-Shun boats. (R. 82-83.)

In the summer of 1949, and while Slo-Mo-Shun IV was under construction, taxpayer consulted with his advisers concerning further development of the basic design and the possibilities of future profits. (R. 29.) He was aware that the articles of incorporation permitted American Properties to construct and sell boats (R. 162-163) and apparently upon the advice of his banker (R. 29) decided to utilize the corporation in carrying on future activities, including the design, maintenance and operation of the Slo-Mo-Shun boats.[9] At a meeting of the board of directors of the corporation, it was decided "to enter this new field and * * * when the time was propitious [for] getting into commercial operation." (R. 29-31.) Thereafter, taxpayer purported to transfer Slo-Mo-Shun III and Slo-Mo-Shun IV to the corporation. (R. 31.) While it is well established that a corporation is a distinct and separate entity from its stockholders, it cannot be overlooked that taxpayer was the sole stockholder of the corporation, that he attended and no doubt conducted the meeting, and that he signed the minutes of the meeting in August of 1949. (R. 27, 86, 92, 93.) The court was justified in looking through the corporate set-up and observing the taxpayer as the real party in interest. *Wisc. Memorial Park Co.* v. *Commissioner*, 255 F. 2d 751

[9] Inasmuch as the actual construction was carried on at the Jensen Motor Boat Company Yard, under the direction of Anchor Jensen, it does not seem likely that American Properties was ever considered in this phase of the operation. (R. 28, 80, 120.) Taxpayer indicated in his testimony that he was interested in designing boats and that someone else would have to build them. (R. 82.)

(C.A. 7th); *Helvering* v. *Scottish American Inv. Co.*, 139 F. 2d 419, 422 (C.A. 4th).

The fourth boat was completed by Jensen in the fall of 1949 (R. 31), and in the summer of 1950, while being driven by taxpayer it established a new world straightaway speed record (R. 32). Thereafter, on July 17, 1950, taxpayer and Jones entered into a contract calling for Jones to design boats exclusively for the taxpayer and the corporation. (R. 32-34, 94-95.) It was contemplated that the contract was to be between the corporation and Jones, but, Jones insisted that, in addition, taxpayer sign it personally. Under this agreement the taxpayer agreed to utilize the services of Jones exclusively in designing racing boats and would pay him $5,000 or 10% of the sales price of each boat *sold*, and in addition would pay time and material charges as in the past. Jones agreed to design racing boats as requested, to disclose to no one the essential features of the design, and to design a new unlimited class racing boat for taxpayer if Slo-Mo-Shun IV was sold at a price greater than cost. The agreement was to remain in effect until terminated by written notice of either party. (R. 33-34.) A few days after the contract was signed Jones won the Gold Cup race for 1950 (R. 34) and was immediately besieged with offers for duplicate boats (R. 211).[10] He and the taxpayer had been enthusiastic about the basic design and were sure that the boat would perform remarkable feats; however, others considered it to be a "backyard

[10] At least two specific offers were for a price of $50,000 per boat. (R. 207-208.)

freak". (R. 211.) Nevertheless, the boat established a new straightaway record and won the Gold Cup, and inasmuch as Jones was interested in making money from his design under the contract (R. 210) he took some of the offers to taxpayer and asked him if they could built boats to fill the offers. The taxpayer immediately refused, saying that they would not be building for anyone. (R. 208.) Taxpayer's continued refusal to consider offers and the other facts of record indicating his desire to be alone in the field (discussion, *infra*),[11] give credence to the following statement of Jones as to why the offers were rejected (R. 208):

> Well, I would have to assume so that there would be no more boats in Slo-Mo-Shun's speed and maneuverability for competition. That is what I gathered from the conversation.

Thus, in the summer of 1950, taxpayers' and Jones' greatest expectation had been realized. Their "back-yard freak" had performed remarkable feats and was widely acclaimed.[12] As the lower court said in its opinion (R. 49):

> It would seem that the "propitious" time for actively going into production and sale would

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[11] Taxpayer insisted in the contract that Jones design for him a new unlimited class boat if one of the Slo-Mo-Shuns was sold. (R. 33.) There is evidence that taxpayer would not sell unless he had another Gold Cup defender, partly because he would lose face in Seattle. (R. 143-145.) And, he evidently felt that Jones was being disloyal in even considering the sale of the Slo-Mo-Shun design. (R. 210-211.)

[12] The boat also won the Harmsworth Trophy in August of 1950. (R. 34.)

have been in 1950 after winning the Gold Cup race.

The corporation did not go into production at that time or even begin preparations for further construction. (R. 34-35, 48-49, 206.)

It is submitted that taxpayer's action in the summer and fall of 1950, despite his testimony, would have been different if he had any intention of making a profit from the design or sale of boats for either himself or the corporation of which he was the sole owner.[13] Even more clearly his actions would have been greatly different, if profit had in fact been his primary purpose and, as seen, the burden was his to

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[13] The lower court was not bound to the testimony of the taxpayer as to his intent because such testimony was refuted by other circumstances in connection therewith. *Penna. R. Co.* v. *Chamberlain,* 288 U.S. 337, 340; *Taitt* v. *Commissioner,* 166 F. 2d 697, 698 (C.A. 5th); *Foran* v. *Commissioner,* 165 F. 2d 705 (C.A. 5th). Particularly is this so because of the oportunity of the lower court to observe witnesses and weigh their testimony in the light of the whole record. *Pool* v. *Commissioner,* 251 F. 2d 233 (C.A. 9th); *Helvering* v. *Nat. Grocery Co.,* 304 U.S. 282; *Heil Beauty Supplies* v. *Commissioner,* 199 F. 2d 193, 195 (C.A. 8th). Unless the record shows that an honest effort was made to conduct a profitable business (*Thacher* v. *Lowe, supra*) and that the venture was conducted in good faith (*Coffey* v. *Commissioner, supra*), the expense incurred in or the losses from the venture may not be considered for income tax purposes. In *Crown Iron Works Co.* v. *Commissioner,* 245 F. 2d 357, the Eighth Circuit had this to say concerning the lower court's function in determining intent (p. 360):

> The question of intent, if at all doubtful * * * is a question of fact for the trial court, and only becomes a question of law for a reviewing court if the evidence is all one way or so overwhelmingly one way as to have no doubt as to the fact. * * *

establish that profit was his primary purpose. The Tax Court was surely warranted in finding that he failed to sustain this burden.

It was not until February of 1951 that any activity was undertaken to design and construct an additional boat. This effort was directed at developing a further improvement in the basic design and to construct a boat to represent the taxpayer at the Gold Cup races of 1951. (R. 34, 100, 207.) The boat was designed by Jones and constructed at the Jensen Boat Company yard. (R. 34.) Both taxpayer and Jones considered that the boat was designed and constructed under the contract between the two of them. And, in addition to the usual payment for time worked and materials, Jones received a fee of $5,000. (R. 100, 206, 207.) A careful review of the contract terms (R. 33-34) will reveal that no provision was made for the payment of $5,000 as a fee to Jones for a boat designed and constructed for taxpayer. He would no doubt be entitled to the usual hourly fee and expenses. Jones considered the arrangements to be for business purposes (and the taxpayer would have the court believe he felt likewise); however, the terms provided for Jones to receive a fee of $5,000 or 10% of the purchase price if higher, for each boat *sold.* (R. 33-34.) All offers received after the design had been established were refused by the taxpayer, and under such conditions it was not possible for Jones to realize any profit from the venture. Taxpayer paid Jones for Slo-Mo-Shun V under the terms of the contract as if it had been sold by the corporation.

The new boat, Slo-Mo-Shun V, won the Gold Cup race of 1951, being driven by Lou Fageol, one of the top drivers in the country. (R. 35.)[14]

In November of 1951, Jones left the Seattle area and carried on his pursuit of designing boats, except those involving the basic design of the Slo-Mo-Shun boats. (R. 35.) He was ready and willing to design additional boats for the taxpayer under the terms of the contract but no other boats were discussed. (R. 206-207.) The completion of V took care of the 1951 season as far as taxpayer was concerned and he "didn't need any more at that time." (R. 207.) After winning the Gold Cup in 1950, taxpayer evidently did not believe the time was right to enter the business of designing, constructing and selling boats; likewise, after his successes in 1951, he gave no evidence of intending to engage in business for profit. The taxpayer no doubt had what he wanted in boats IV and V—racing one or the other, he won four straight Gold Cup races and many other prizes and honors. (R. 35.) In this regard, it is not disputed that racing boats in competition is an effective way of proving their worth and selling potential. However, taxpayer's activities over those years (1949-1953) establish conclusively that he was pursuing his

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[14] The Slo-Mo-Shun boats won the Gold Cup in 1952 and 1953, and won many other important trophies during the years 1950-1953. Four different men drove the Slo-Mo-Shun boats to their victories in 1950-1953, i.e., Ted Jones, Lou Fageol, Joe Taggart and Stanley Dollar. None of these men were employed by the taxpayer or the corporation (except Jones for the short while in 1951) and they were either wealthy sportsmen or top race drivers. (R. 34-35, 122-123.)

hobby and was not seriously considering the possibilities of profit in the sale of the design.[15]

Jones did not give notice of termination of the contract but honored its terms for about three years. (R. 207.) He then began to design unlimited class boats, principally using the basic design of the Slo-Mo-Shun boats. Fifteen or so of his boats are in service and all but three or four follow this basic design. (R. 35-36, 206-207.)

This record of the action of the taxpayers over the years (without more) supports fully the Tax Court's statement that (R. 47):

> * * * we do not doubt that the petitioner and others held the belief that there was a profit possibility, we do not believe * * * that there was an intention or motive of immediately embarking upon a business venture. Rather, we believe that the parties had in mind merely the possibility of entering into a commercial venture at some future time when it might be deemed expedient to do so. The evidence shows that this never did eventuate.

A study of the court's findings and opinion shows that, in arriving at the above conclusion it did not overlook any of the facts of record, including evi-

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[15] It is undisputed that speed boat racing was taxpayer's hobby up to 1949 (R. 44, 67-68); and that after that time, as he admitted, driving and testhopping boats was a hobby (R. 100-101). In addition, it is important to note that in August of 1949, according to minutes of the meeting of the board of directors of American Properties, taxpayer "had no doubt of the salability of Slo-Mo-Shun the IVth and boats of that design and class". (R. 30-31.)

dence of a loan of $26,000 in 1951 to the corporation to use in the boat operation (R. 34); a loan made by a bank whose loan officer had been taxpayer's financial adviser for 20 years; a loan made to a corporation which had a surplus of over 70 thousand dollars in 1949 and 1950, and whose sole stockholder was a successful businessman and leading civic leader in Seattle (R. 38, 113, 125, 126).[16]

In completing the picture of taxpayer's activities and in arriving at a determination of his intention to operate a business for profit, the court was authorized and required to consider, in addition to evidence of the conduct of the venture (which has been discussed in detail *supra*), his financial and social position and his regular business and outside activities. *Coffey* v. *Commissioner, supra; Ewing* v. *Commissioner, supra.* Among other things, the following bear upon these considerations, and together with the record of the operation of the boat venture throughout 1949, 1950 and 1951 and subsequent years, furnish ample justification for the ultimate finding that the expenses were in furtherance of taxpayer's personal hobby and not in the conduct of a trade or business for profit.

The taxpayer was a prominent sportsman who gained national fame as an owner and driver of high

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[16] The Tax Court was not unmindful of the question as to whether the title to the boats passed to and lodged in the corporation. It noted properly that the answer to the question itself is not decisive, "but is merely one of the factors involved in the more important question of whether the corporation did enter into a true business venture of exploiting these racing boats for profit." (R. 45.)

speed, unlimited class power boats and was selected as "The Man of the Year" of Seattle in 1950 (a top sports achievement award). (R. 30, 68, 69, 73.) While he did not drive his boats in closed course races, he did drive in competition and established the world's speed record for a straightaway course. (R. 88, 89.) He personally spent large sums of money (at least $100,000) in the design, construction, maintenance and operation of his unlimited class boats. (R. 109-113.) Taxpayer advised a newspaperman in 1953 that he personally spent more than $100,000, that no one had advised him of how to get any tax benefit therefrom; that he personally financed "entirely" the costs of operating the boats in the Gold Cup races in 1950 and 1951 (R. 109); that he personally made up the loss in the expenses of the Gold Cup race in 1952; and that any deficit in 1953 would be absorbed by him (R. 111, 113; Exs. K, L). Earlier (June, 1952), in an interview with a newspaperman (R. 129-130; Ex. N) he had referred to the design and operation of the boats as his personal hobby and of the fact that it was becoming very expensive. It appears as a result of this interview and the report thereof, that Greater Seattle undertook to help finance future operations. (R. 130; Ex. O.) In these and other ways taxpayer held himself out as the owner and operator of the boats, and referred to such activities as a hobby. (R. 127-130, 135-136; Exs. K, L, N, O.) It seems clear that the general public in the Seattle area considered the taxpayer to be the owner of the boats and that racing speed boats was his hobby; and taxpayer made no serious effort

to dispel such an impression. (R. 127-128, 135-136.) This understanding on the part of the public was evident in the response to the annual campaigns conducted each year by Greater Seattle [17] to assist taxpayer in defraying his expenses of preparing for and racing the Slo-Mo-Shuns in competitive races. (R. 130, 133, 134, 135.) In conducting such campaigns and in programming the races in the water shows, Greater Seattle publicized the taxpayer as the owner of the boats and he did nothing to deny such personal ownership. (R. 136, 138, 139.) The Tax Court was surely warranted in doubting that a man of taxpayer's community standing would have permitted public subscriptions on the public understanding that the operation was a non-profit hobby, if such had not been the fact. (R. 50.) Furthermore, the taxpayer listed himself as owner of the boats in 1950 and 1951 in executing forms for personal property taxes (R. 31-32); registered himself as the owner of the boats with the Seattle Yacht Club and the American Power Boat Association (R. 32); and had his

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[17] Greater Seattle was a non-profit corporation organized to sponsor sporting events and other functions in the interest of building up the City of Seattle. Concerning the campaign to assist him, taxpayer testified (R. 135-136):

Q. [By Mr. Cromwell.] Did Greater Seattle ever sponsor any campaigns to raise money for you to operate these boats, Mr. Sayres?
A. Yes.
Q. Did they advise the public that the American Properties, Inc. owned these boats?
A. I don't think so.
Q. Did they hold you out as the owner of the boats?
A. I can't answer that flatly, I would assume, Yes.

name placed on all cups and other trophies won by the Slo-Mo-Shuns (R. 123, 126).

Finally, it must not be overlooked that neither the corporation nor the taxpayer ever constructed any boats for sale; never made an effort to sell any boats, and in fact never sold any boats (although taxpayer had offers to do so).[18] Taxpayer considered the boats to be his and he was not interested in disposing of any of them. There is no question here, as there is in most cases involving this issue, of whether the sales or income over the years is of sufficient volume to constitute a business. Here there was no production, no sales, and thus, no income. It is not possible to even consider the principle that in order to constitute a bona fide business, the gross receipts must have substantial relation to the expense of operation. *Cecil* v. *Commissioner*, *supra*, p. 901.

If this Court upholds the Tax Court's finding that the expenditures made by the corporation in the boat venture were for the personal hobby of the taxpayer, then it follows that the Tax Court was correct in holding that the expenses were properly chargeable to the individual taxpayers as income. As noted by the lower court in its opinion (R. 52-53), "It is well settled that payments made by a corporation on be-

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[18] As a matter of fact taxpayer had received many offers to sell his boats and the designs before he conceived the idea of shifting the burden of financing his hobby to one of his corporations. The minutes of the meeting of the directors of American Properties in August, 1949, contains this notation (R. 30-31): "Mr. Sayres also advised that he had substantial offers for Slo-Mo-Shun III * * *."

half of its stockholders may constitute taxable dividends to the stockholder." Particularly is this true if there is no business purpose involved. *Lengsfield* v. *Commissioner*, 241 F. 2d 508 (C.A. 5th); *Byers* v. *Commissioner*, 199 F. 2d 273 (C.A. 8th). The corporation had a surplus at the end of 1949, in the amount of $74,659.49, consisting in part of $37,497.43, in earned surplus; and a surplus of $71,260.73 at the end of 1950, of which $34,098.67 was earned surplus. (R. 38.) There was no evidence introduced to indicate that the earnings were not available for disbursement to the sole stockholder in the amounts expended in the boat venture, which did not exceed $33,009 for the two years involved. (R. 217.)

CONCLUSION

We submit that the Tax Court's findings are amply supported by the record and that its decisions are correct and should be affirmed.[19]

Respectfully submitted,

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
I. HENRY KUTZ,
C. GUY TADLOCK,
Attorneys,
Department of Justice,
Washington 25, D. C.

OCTOBER, 1958

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[19] It is noted that part of the deficiency against the individual taxpayers for fiscal 1950 is not in dispute. (R. 60; Br. 3.)

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transactions of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121, Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.

* * * *

(l) [As amended by Sec. 121, Revenue Act of 1942, *supra*] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses;

* * * *

(26 U.S.C. 1952 ed., Sec. 24.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.22(a)-1. *What Included In Gross Income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22(b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. * * *

* * * *

Sec. 29.23(a)-1. *Business Expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the tax-

payer's trade or business, except the classes of items which are deductible under sections 23(b) to 23(z), inclusive, and the regulations thereunder. * * *

* * * *

Sec. 29.23(l)-1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, may be deducted from gross income. * * *"

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